Cooperative Equity and Ownership:

An Introduction

By Margaret Lund

With thanks to:
Lynn Pitman, *University of Wisconsin Center for Cooperatives,* Editor and contributor

Margaret Bau, *U.S. Department of Agriculture*
Courtney Berner, *University of Wisconsin Center for Cooperatives*
Brent Hueth, *University of Wisconsin Center for Cooperatives*
Anne Reynolds, *University of Wisconsin Center for Cooperatives*

Cooperative Equity and Ownership: An Introduction is published by the
University of Wisconsin Center for Cooperatives
April, 2013

www.uwcc.wisc.edu

Contents

1. INTRODUCTION 4
2. CO-OP CAPITAL BASICS 6
   Equity And Essential Issues Of Ownership 6
3. START-UP CAPITALIZATION AND EQUITY STRUCTURES 9
   Co-op Member Equity Structures 10
   Other Possible Start-Up Funding Strategies 13
   Debt and Co-op Member Loans 18
   Debt and Equity Compared 20
   How Much Capital is Necessary to Start a Cooperative? 21
4. ONGOING CO-OP CAPITALIZATION 26
   Allocation considerations 29
   Equity Redemption Plans 31
   Thinking about Equity 36
5. BENEFITS OF COOPERATIVE MEMBERSHIP 39
6. CONSIDERATIONS AND CONSEQUENCES OF CAPITAL DECISIONS 45
   Building your Co-op for the Long Haul 45

1. INTRODUCTION

"Not for profit, not for charity, but for service" is one common way that credit unions differentiate their activities from those of other economic enterprises, and it works well as a concise and accurate descriptor for the whole cooperative sector. Cooperatives are business enterprises, not charitable organizations, so they are not the same as non-profits; yet they do not exist to maximize profits, so they are not the same as investor-owned firms. Cooperatives are enterprises that are democratically owned and controlled by the people who benefit from them and are operated collaboratively for the purpose of providing services to these beneficiaries or members.

The International Cooperative Alliance defines a cooperative as "an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise." A co-op is an enterprise formed by a group of people to meet their own self-defined goals. These goals may be economic, social, cultural, or as is commonly the case, some combination.

In a cooperative, only participants who have met the requirements for membership are allowed to be owners. All cooperatives operate on the principle of "one member, one vote", so *control is allocated evenly among the users of the co-op without regard to how much money each has invested*. Cooperatives operate for the benefit of members, and those *benefits* are distributed in proportion to each member's transactions with the cooperative. In a co-op, the answer to the question of "who owns, who controls and who benefits from the enterprise?" is always the same – the cooperative members.

Cooperatives operate in virtually every country in the world, and in almost every kind of industry. They can be organized and owned by workers, consumers, producers,

small businesses, other cooperatives or even some combination of these categories. All cooperatives, no matter the size or sector, adhere to a common set of principles expressing their foundational values of democracy, equality, equity, self-help, self-responsibility and solidarity.

Given these shared core principles and common objectives, however, the exact way in which each co-op is structured can vary enormously. The purpose of this manual is to provide an introduction to one very important aspect of cooperative enterprise, that of member economic participation through the co-op's ownership or equity structure. While the manual is not intended to cover every situation or sector (we do not discuss housing cooperative, for example, a topic that would take a manual all its own), it is designed to provide a basic introduction to the underpinnings of the cooperative model of ownership as well as an understanding of some of the practical applications of its use.

The Cooperative Principles

1. Voluntary and Open Membership

Cooperatives are voluntary organizations, open to all people able to use its services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.

2. Democratic Member Control

Cooperatives are democratic organizations controlled by their members—those who buy the goods or use the services of the cooperative—who actively participate in setting policies and making decisions.

3. Members' Economic Participation

Members contribute equally to, and democratically control, the capital of the cooperative. This benefits members in proportion to the business they conduct with the cooperative rather than on the capital invested.

4. Autonomy and Independence

Cooperatives are autonomous, self-help organizations controlled by their members. Any agreements with other organizations or external sources of capital ensure democratic control by the members and maintain the cooperative's autonomy.

5. Education, Training and Information

Cooperatives provide education and training for members, elected representatives, managers and employees so they can contribute effectively to the development of their cooperative, and inform the public about the nature and benefits of cooperatives.

6. Cooperation among Cooperatives

Cooperatives serve their members most effectively and strengthen the cooperative movement by working together through local, national, regional and international structures.

7. Concern for Community

While focusing on member needs, cooperatives work for the sustainable development of communities through policies and programs accepted by the members.

Source: The International Cooperative Alliance

2. CO-OP CAPITAL BASICS

Equity and Essential Issues of Ownership

So what does it mean to be, as a cooperative is, “owned and controlled by the people who benefit from its services?”

Some definitions and differences

In finance and accounting, "equity" is commonly defined in a residual manner -- it is what is left over after all of the debt and other obligations (liabilities) of the company have been paid. Equity is what belongs to the owner(s) of a firm and theoretically includes all that the owners have invested in the company over time, including funds used to start the company, annual earnings that have been retained in the company over the years, and any ongoing investments that have been made to replace and improve the organization's assets. It also sometimes includes intangible assets such as brand name or good will. Member-owners of a cooperative contribute to and democratically control equity capital, and receive a share of the profits based on their patronage, or use of the co-op’s services.

Ownership of any enterprise generally yields the right to a certain degree of control of that enterprise. Ownership is also linked to what in finance are called “residual claimant rights”, which are rights to a particular share of company net income while operating, or a claim of divided assets if the company is dissolved. In most companies, the more money a person invests, the more equity in the business he or she would own. Both control and financial rewards are driven by the amount of money invested and the more of one, the more of the other.

Cooperatives are distinguished from other organizations in that member use, or patronage is linked to control of the enterprise, rather than the degree of monetary

investment. Any financial returns to cooperative owners typically come through profit allocation based on their patronage, or transactions with the cooperative. This is very different from an investor-owned firm where it is not necessary to transact any business with the enterprise in order to benefit from it as an owner. In an investor-owned firm, return comes through funds invested, not services used.

Cooperatives also differ from nonprofit organizations, which do not issue stock and do not have individual owners at all. Most nonprofits are chartered for cultural, educational and/or charitable purposes and their activities are generally limited to such activities. Any surpluses earned must be retained and reinvested in pursuit of the organization's stated aim or distributed to another non-profit. Control may be exercised by an elected board of "members" of the association as dictated in its organizing documents, but nonprofits are also frequently controlled by a self-perpetuating board where current board members select their own replacements.

The following chart summarizes some key differences in business structure:

	Cooperative Corporation	**C Corporation**	**Sole Proprietorship**	**Nonprofit organization**
Who are the owners?	Members	One or more shareholders.	Individual	No ownership
What is the business purpose?	To meet member needs for goods or services	To earn a return on owner investment	To provide owner employment a return on owner's investment	To provide services or information
How is the business financed?	stock/shares to members, and sometimes outside investors; retained profits	Sale of stock; retained profits	Proprietor's investment; retained profits	Grants, individual contributions, fees for services
Who receives profits?	Members in proportion to use; preferred stockholders in proportion to investment, up to 8%	Stockholders in proportion to investment	Proprietor	Retained within the organization
What is owner legal liability?	Limited to members' investment	Limited to stockholders' investment	Unlimited for proprietor	Limited to assets of the organization

Adapted from the University of Wisconsin Center for Cooperatives website: www.uwcc.wisc.edu/whatisacoop/BusinessStructureComparison

Risk and reward

In any business enterprise, assets are those things of value (cash, inventory, equipment, accounts receivable) that are *owned* by the company, liabilities are those things of value (accounts payable, loans) that are *owed* by the company to others, and *owner equity* is the difference between the two. In the event of a business failure or dissolution, it is the equity holders or owners who would be the last to be paid. Because they are the last claims to be paid, equity funds are fundamentally at risk. This is a very important consideration for any business. *What ensures the eventual return of equity capital to the owners is the sound and profitable operation of the business and nothing more*. This is true for both cooperatives and other types of business entities.

To compensate for the higher risks they face, most business analysts agree that ownership shares deserve higher rates of returns than borrowed capital. In investor-owned firms, this return is variable and unlimited based upon the success of the enterprise. (combine with para below)

Cooperatives differ fundamentally from other business entities in that they do not promise unlimited -- or even particularly high -- rates of return in exchange for the risk of ownership. Instead, cooperatives offer their members the advantages of a democratically governed enterprise directed toward meeting the needs of participants. Some of the benefits of cooperatives are clearly economic, while others are less easy to calculate, but are just as important. Section 5 discusses some of the diverse ways that cooperatives can benefit their members beyond a simple return on equity capital invested.

3. START-UP CAPITALIZATION AND EQUITY STRUCTURES

All businesses require capital to buy equipment, purchase inventory, secure work space, pay staff and cover other necessary expenses. “Member economic participation” is one of the key co-op principles. This means that in a co-op, not only do members share in the economic rewards of the co-op; they also share responsibility for making sure the co-op has the capital it needs to operate effectively.

The amount of funds needed, as well as the potential sources of capital, will vary depending upon the size of the business, industry and stage of operations. Some industries are much more capital-intensive than others and may require significant funds just to get started. Others exhibit a lengthy operating cycle between when goods are produced and when final payments are made by the end users, requiring the business to secure large amounts of "working capital" to pay the bills in the meantime. In still other cases, the addition of a new production or sales site, or the expansion into a new territory or product line, will require additional funds. In all of these cases, the capital needed by the co-op must be planned for and secured by the co-op members.

Start-up capital can be some of the most challenging to secure because the co-op has no operating history to rely on. Small business experts cite failure to plan for and raise sufficient capital as one of the most common causes of failure for new businesses, and cooperatives are no exception. Therefore it is well worth paying some significant attention to this issue prior to the launch of a new cooperative venture.

Cooperatives typically finance their start-up needs with a combination of debt from lenders and at-risk equity investments from the co-op members. Important decisions about member equity structure begin at incorporation, which happens on a state level. State statutes governing cooperative incorporation are not uniform and vary

quite a bit from state to state. Therefore a cooperative organizing group would be well-advised to secure some expert advice to make sure their co-op capital structure will meet their capital needs.

Co-op Member Equity Structures

Depending on state statute, cooperatives may have the choice to incorporate as either a stock or non-stock businesses. If organized as a stock cooperative, the founding members specify in the articles of incorporation the amount and the classes of stock[1] that the cooperative may issue. Cooperatives may amend the articles in the future to issue additional shares or another class of stock.

Through their purchase of shares of stock from the cooperative, members provide the equity capital that the cooperative enterprise needs to launch and grow. Because cooperatives are organized around the democratic principle of one member/one vote, stock cooperatives will all have at least one class of member stock, often referred to as "voting stock." Ownership of this kind of stock is limited to one share per person and confers membership and voting rights to the holder. Voting stock rarely pays a dividend or financial return – its value is in the control rights it

Stock and Member Equity

A stock structure can provide flexibility in both start-up and continuing capitalization strategies. People's Food Cooperative of La Crosse, WI requires the purchase of a share of membership stock, designated as Class A, with a par value equal to the member fee set by the bylaws. In keeping with the principle of "one member, one vote", only one share is issued to each member, and it entitles the member to vote and democratically participate in the affairs of the co-op.

People's also requires members to purchase three shares of Class B stock, which has a par value of $25 and carries no voting rights. This second class of stock allows some flexibility for the co-op to vary equity requirements by member type, independent of voting rights. It also allows the co-op to vary its redemption policies for different classes of stock.

www.peoplesfoodcoop.com/articlesandbylaws

[1] The terms "member shares" and "shares of stock" are used interchangeably here.

confers. Because ownership of voting stock in a co-op is limited to active members, this stock is generally redeemed at par value (original purchase price) by the cooperative when a member leaves. The par value of the member stock varies greatly from co-op to co-op and industry to industry and can range from $10 to tens of thousands of dollars.

Cooperatives may want to tie additional upfront equity investment requirements to membership, or to projected use of cooperative services. In such cases, other nonvoting classes of stock with different par values and different redemption policies may be issued in exchange for these additional equity payments. These classes of stock may or may not pay dividends. (See sidebar.)

"Preferred" shares are an additional class of stock that many co-ops find it useful to issue. Preferred shares receive priority over other classes of stock in the event of dissolution and also typically offer a dividend to holders. In most cases dividends on preferred shares in a co-op cannot exceed eight percent, in keeping with the Internal Revenue Service definition of "operating on a cooperative basis." Some state statutes also contain restrictions on the maximum return that can be paid to holders of preferred shares in a cooperative. Because this type of stock does not confer member voting rights, preferred shares in a co-op can be offered to nonmembers in addition to members. This is a common way for some kinds of cooperatives to raise additional capital from a wide range of supportive individuals or organizations, getting the funding they need more quickly than they could by relying

Preferred Stock and Equity Payments

CROPP, the farmer cooperative that markets under the Organic Valley brand, uses preferred stock as a way to return dividends to their members on initial equity payments.

CROPP's dairy pool members are required to participate in a Capital Base Equity Program, in which the equity payment required of each member is equal to 5.5% of a member's estimated annual gross income from products marketed with the co-op. The payment can be made over time. Once the member has acquired sufficient shares, their equity is transferred to Class B preferred stock.

The member may choose to receive the dividend in cash, or have it reinvested in the Class B preferred stock.
http://www.farmers.coop/producer-pools/dairy-pool/equity-story/

only on members contributions or retained earnings. Co-ops also sometimes use this class of stock to give members an incentive to place additional equity in the co-op, or as compensation to members for maintaining a significant equity balance (see sidebar). Depending on state statute, holders of preferred shares may enjoy limited voting rights on major issues such as merger or dissolution that would directly affect the value of the shares.

Most cooperatives require that member shares be paid out-of-pocket at the time the member joins. If the cost of membership is significant, many will allow the payment to be made over time, or for patronage rebates to be applied to any balance still owed. Marketing cooperatives often use a "per-unit retains" system, where member agree to allow the cooperative to deduct a small portion of the proceeds of the sale based upon the volume of product marketed through the co-op. Co-ops will need to balance the preferences of members to pay for their shares over time with the needs of the cooperative to have sufficient member capital for start-up and growth.

Stock cooperatives have flexibility to allow for more than one class of shares to be issued as part of the initial equity drive, or at a later date to finance future expansions or growth or if the co-op is undercapitalized. If the articles of incorporation did not originally specify additional classes of stock, the articles can be amended to add a class of stock as the need arises.

Non-stock cooperatives are an alternate way of allocating financial interests in a cooperative. The difference between the two depends upon state statute and is another area where guidance from a qualified attorney with experience in cooperative law is essential.

Cooperatives typically limit the sale of shares to members only, and the only permissible re-purchaser of shares is the co-op itself. Stock is sold back to the cooperative at par (face) value unless other provisions have been stipulated in the articles or bylaws. For instance, a cooperative may state that it will buy back stock at par value or book value, whichever is lower.

Most co-ops have an internal schedule outlining the expected timing of the re-purchase of members' shares, but the timing typically is subject to board approval and is dependent upon the current financial needs of the cooperative.

In practice, this situation is not much different from other privately-held companies. All privately-held companies, including cooperatives, are constrained by the limited universe of potential purchasers of their shares. Absent takeover by an outside buyer, in practice re-purchase or redemption of shares in a privately-held company, cooperative or not, is dependent upon the cash flow and financing needs of the business.

Co-op Stock and the SEC

One consideration in planning to issue a class of stock is whether it meets the SEC definition of a security, and whether the sale of stock remains in-state.

If stock meets the definition of security and is sold in multiple states, the cooperative will likely be subject to federal securities laws that require registration and reporting to the SEC, a complex and potentially costly process. If co-op stock is sold within a state, however, state and federal laws may exempt the co-op from this type of reporting and registration.

It is important to consult an attorney or financial expert before making a stock offering. A member loan program may fall under the same requirements (see "Start-up Capitalization – Member Debt").

Other Possible Start-Up Funding Strategies

Sometimes organizing groups find it challenging to raise enough at-risk equity for their new cooperative venture simply through the sale of stock or shares to potential members. In these cases, some other structures or strategies might be considered to raise additional at-risk funds.

Nonprofit organization

Depending upon the proposed membership base and activities, if organizers anticipate an ongoing need for grants or subsidies to carry out core activities, it may make sense to consider a nonprofit structure. While state statutes vary, incorporating as a nonprofit typically means that there is no owner or group of owners who have an

equity stake in the organization and who are entitled receive any surplus from its activities. A nonprofit organization can elect its board democratically from amongst its members, however, and in other ways operate on a cooperative basis.

A co-op organizing group that has shorter-term need for donated capital (to offset planning or training expenses, for example, or to assist with one-time start-up costs) and that will deliver clear social as well as individual benefits like affordable housing or employment for the disadvantaged, might be able to secure a one-time set of donations through an affiliated nonprofit rather than organizing as a nonprofit themselves. This would enable them to retain the flexibility to use the cooperative structure to financially benefit their low-income or disadvantaged members in the future.

Supporting a Food Shed

Fifth Season Cooperative was incorporated in 2011 to build a regional food system that supports healthy environment, a strong economy, and thriving communities.

Membership classes include key participants in the local food shed: individual producers, producer businesses, food processors, distributors, wholesale food buyers, and the workers who are employed by the cooperative.

In one sense, each member class has potentially competing interests - producer members might be driven to seek the highest price for their product, for example, while buyer members might seek the lowest. However, Fifth Season members realize that while they may be on opposite sides of the table in any given transaction, there is a broader benefit to their cooperation. It is the long-term relationships between growers and buyers that support fair pricing and treatment all along the supply chain which will benefit all and keep dollars circulating in the local economy.

Member stock for individual producers and workers is $250, while the remaining classes have an equity contribution requirement of $750. Producer, buyer, and worker memberships each elect a board member; the remaining directors are elected by the entire membership.

Multi-stakeholder cooperatives

Cooperatives are typically organized to meet the needs of one particular type of member – selling groceries to consumer members for example, or marketing products for farmer members. However, in some countries, including the U.S., there is increased interest in the multi-stakeholder cooperative model. Multi-stakeholder cooperatives allow for ownership and governance by two or more stakeholder groups who share a common goal that is

broader than the interests of each individual stakeholder group. Members may include consumer producers, workers and/or outside supporters, and provide a broader base of equity investment for the cooperative.

In a multi-stakeholder cooperative, each class of member may have different equity requirements, allocation of board seats and share of net earnings. A co-op that creates a category of "supporter member", for example, may do so to attract capital from community members who are broadly supportive of the co-op's mission, but may not meet the definition of a worker or patron member. Co-ops that use the flexible multi-stakeholder approach can thus require relatively larger amounts of invested capital from one kind of member, yet allocate more control rights in terms of board seats or financial return in terms of patronage to a different class of member, in keeping with the overall mission and objective of the cooperative.

Limited cooperative association (LCA)

Some states allow for the formation of limited cooperative associations, a new form of co-op that permits a class of investor members in addition to traditional patron members. Unlike traditional cooperatives, a limited cooperative association gives investors ownership status with member voting rights, a claim to profits, and the right to be elected to the board in exchange for their equity participation. The specifics in the state statutes vary widely in the measure of protection provided for patron control.

While attracting outside capital was a primary reason cited for passing the new LCA statutes, in practice they have not been widely used. Some in the cooperative community have expressed concerns that this structure dilutes core cooperative principles by allowing the interests of non-patron capital investors to have ownership and control rights that could potentially conflict with the interests of the patron members. And from a typical investor perspective, the LCA structure may not provide the level of control and potential financial return to attract significant capital investment.

However, in some situations there is commonality of interests beyond the financial that may exist between investor- and patron-members. Investor-members may be motivated by community development as well as financial considerations to provide patient equity capital for projects that otherwise might not be able to attract sufficient capital for start-up. For co-ops serving low income communities or in other ways have a charitable purpose like affordable housing or employment for the disabled as part of their mission, a creative use of the limited cooperative association statute also allows for a sympathetic nonprofit to act as an investor member. In this way grant funds may be targeted to the co-op through the nonprofit member without the difficulty of forming the cooperative itself as a nonprofit charitable organization. As an investor member, the nonprofit can exercise oversight over the appropriate use of charitable funds, but otherwise leave day-to-day governance activities to the co-op's beneficiary members.

Targeted use of limited liability companies or joint ventures

Sometimes when a co-op is trying to raise money for a high-cost capital expenditure such as a new building, it makes sense to partner with others in the ownership of that specific asset alone, rather than ownership of the entire cooperative enterprise. A co-op can form a limited liability company (LLC) or other joint venture with some investor partners to own a building or production facility for example, without opening the ownership and operation of the entire co-op up to investor influence. A co-op could also use a single-purpose LLC to gain critical expertise in sophisticated business activities such as brand marketing, while preserving the ultimate control of that brand for the producer-members alone.

Cooperative partnerships

One of the unique aspects of the cooperative enterprises is the common principles that govern them. Cooperation among cooperatives is a principle that recognizes the benefit to individual cooperative efforts from cooperation with other cooperatives at a local, regional, and national level. Some co-ops do this through informal advice, others by showing preference to other cooperatives in their purchasing

activities. Still other cooperative take it a step further and use their own capital as mature co-ops to help new co-operative ventures.

Replicating Worker-Owned Cooperative Bakeries

Disappointed with the slow pace and high failure rate that seemed endemic to the one-by-one approach to cooperative development, in the mid-1990's a group of San Francisco Bay Area cooperators developed a different structure for starting new co-ops, the Arizmendi Association of Cooperatives.

Arizmendi is a network of like-minded worker-owned bakeries, but also much more than that. Arizmendi is also serves as a technical assistance provider and incubator for new cooperative members of their association, vetting potential store locations, recruiting members, securing loans and other capital and giving the new bakeries access to its tested product line and unique recipes. New and existing Arizmendi bakeries then continue to advertise together, back each other up and share a range of common support services. The association even houses some of the same sourdough starter culture for members.

Funding for such start-up technical assistance for new worker co-ops is often difficult to come by, but Arizmendi has developed a self-supporting system that allows them to nurture new member co-ops without need for constant subsidy. Key to this strategy is their focus on one type of business. Also key is the Arizmendi approach of facilitating assistance between established worker co-ops and emerging ones. Rather than try to become experts in a whole range of industries, the three founding members of Arizmendi decided to choose one of the most successful existing worker co-ops in their area, and then create more of those.

In the 1995 the organizers approached the Cheese Board, a thriving artisanal cheese and bread store located in Berkeley with the idea of helping to create more such businesses and linking them together. Cheese Board Collective members generously offered free use of their recipes and insight into their organizational structure as well as startup funding and use of their name in marketing. With this backing, the first new Arizmendi bakery was on its way.

The Arizmendi co-ops now number five in addition to the original Cheese Board. All Arizmendi bakeries contribute a percentage of their net income as membership fees to the Association to help pay for technical assistance and shared services. If the co-op is not yet profitable, they don't have to pay until they are, but every member still receives services. As the member bakeries grow and become more successful, funding for the Association increases, and more funds are available for new co-op development.

www.arizmendi.coop
Marraffino, Joe (2009). The Replication of Arizmendi Bakery: A Model of the Democratic Worker Cooperative Movement. Grassroots Economic Organizing (GEO) Newsletter, Volume 2, Issue 3, http://www.geo.coop/node/365

Debt and Co-op Member Loans

The capital structure of an enterprise typically includes both equity (that is, capital funds that are provided by the owner(s) of the enterprise) and debt, which are funds that are borrowed from others that do not represent ownership interests. One common way of expressing this is that the balance sheet of a business is made up of "what you owe and what you own."

Debt differs fundamentally from equity in the areas of risk, return, and control. Debt is a contractual obligation that must be repaid according to the terms of the debt agreement or loan note. The return to the lender is generally set at a particular rate of interest and the term of the debt is fixed for a particular length of time. While the financial return to business owners may be variable and is dependent upon the success of the business, that is not generally the case for lenders. Lenders don't get paid more if a business does particularly well, nor does the debt obligation go down if a business falters.

Debt also differs from equity in its liquidity. Debt instruments have a specific and legally binding schedule for liquidity, with regular repayments of principal according to a mutually-agreed upon schedule. The schedule for paying a return to owners in terms of dividends on equity shares, on the other hand, is dependent upon the profitability of the business. The schedule for redemption or cashing out of ownership shares is also dependent upon the cash flow position of the business. Cooperatives will often set out a preferred schedule by which they intend to redeem members' shares, but that is only a guideline. The declaration of dividends or redemption of cooperative shares is always at the discretion of the board. While lenders have a limited and short-term interest in a business, owners are expected to demonstrate a long-term commitment to enterprise success, which might require at times elevating the needs of the cooperative as a whole over the preferences or interests of individual members.

Lenders enjoy greater protection than owners in the event of business dissolution. In return, however, they have only a very limited ability to influence the

actions of the company. Thus holders of debt do not have any control rights except the right to enforce the terms of their loan agreements with the company. Owners, not lenders, are the decision-makers in a company, and they bear both greater risk and greater reward for the consequences of those decisions. For cooperative members, the risks of ownership are offset by the range of benefits, both financial and nonfinancial, that may be received through the successful operation of the co-op.

As with other business entities, outside lenders expect cooperative member owners to have a substantial level of equity investment in the firm before they will consider putting their debt capital at risk through a loan. One option that cooperatives have that often helps to entice outside lenders such as banks to take on the risk of working with a cooperative is to institute a member loan program to finance a portion of a cooperative start-up. Member loans are loans made to the co-op by its members. In cooperatives, member loans are generally subordinate to loans that are made to the co-op by outside lenders, and are therefore considered "quasi-equity" by many lenders. For an outside lender, cooperative member loans would be seen as akin to the "friends and family" loans that are often seen capitalizing individual small businesses.

(combine with para above)Unlike a "friends and family" loan, however, a cooperative member loan program is seen to be a sale of securities, and thus needs to be structured according to state law with in-state considerations similar to the sale of cooperative stock (see page 13).

As fixed obligations that pay interest, member loans carry less risk to members than equity, because in case of liquidation, they are paid off before member equity (i.e. stock or shares). However, member loans are unsecured (they do not have collateral), as opposed to secured (collateralized) debt from a bank or other lending institution, and thus still carry risk for the member.

Debt and Equity Compared

Equity and debt differ in their risk, return, and timing of redemption. Often a combination of debt, equity, and perhaps intermediate instruments such as preferred shares or members loans will together make up the optimal package for financing a new cooperative. The availability of each of these financing tools is strictly governed by state law, so any co-op considering their use will need the advice of attorney familiar with state and federal securities law and cooperative statute.

	Member/Common Stock	**Preferred Stock**	**Member Loans**	**Outside "bank" debt**
Risk	Highest	Redeemable before common stock but subordinate to all debt holders	Superior to equity shares but generally subordinate to outside lenders	Lowest; generally paid first in a dissolution
Return	Generally none directly, although ownership of common stock yields rights based on patronage to share of the co-ops annual surplus, which could be significant.	Can be variable; usually limited to 8% maximum; most co-ops post an expected dividend rate but declaration of the dividend is dependent upon the co-op's profitability and board approval; dividends receive priority over other allocations of net profit.	Fixed; interest rate is set in the loan note. Sometimes payment (as opposed to accrual) of interest to members will be restricted by the lead lender until profitability has been established	Fixed and regular according to loan documentation. Not dependent on profitability.
Redemption	The most illiquid; generally will be redeemed when a member leaves the co-op subject to action by the board	Usually has a target date for redemption, subject to financial conditions and board approval.	Fixed date stated in loan documents.	Fixed date stated in loan documents.
Control Rights	Full; only holders of common stock may exercise control rights in a co-op	May have limited voting rights on mergers and dissolution, although sometimes purchase of preferred shares is limited to holders of common stock.	None, except as holders of common stock; debt confers no control rights	None. Debt confers no control rights
Flexibility	The most flexible source of funds	The second most flexible source of funds	Also a flexible source of funds, although return rates and redemption dates are more firmly fixed than with equity	The least flexible source of funds; interest rates and payment schedule firmly fixed and

			shares	other financial covenants, limitations may apply

How Much Capital is Necessary to Start a Cooperative?

One of the most important decisions a new cooperative board will make is what equity investment will be required of each new co-op member. Member economic participation is a core cooperative principle, and one of the ways that co-ops differentiate themselves from other kinds of enterprises. Co-ops are self-help organizations, and part of self-help is that every member contributes financially in some way to the well-being of the co-op, just as every member will later benefit when the co-op distributes its surplus in an equitable fashion back to the members. The amount of equity (and subordinate debt) that can be supplied by members will in turn influence the amount of debt the co-op might raise and therefore the total capital available to start operations.

A first step might be to estimate out how much total capital is needed to launch the business. Many founding boards start with a figure of how much money they think they *can* raise to get their new co-op started and work from there. However, it is far better to start with an estimate of how much money they will *need* to raise in order to start such an enterprise, and then think about the equity structure and membership composition that must be in place to support a business of that nature.

So how much is enough? That depends on a number of factors including:

- the equipment and other fixed assets needed to run the business;
- typical business cycles or payment practices in the industry;
- resources available from partners such local community entities, vendors, or other cooperatives;
- lenders' tolerance for risk and therefore how much debt the project can leverage;

- available pool of potential members; and
- the preferences of the founders.

A feasibility study for the proposed cooperative is the first step in estimating start-up capital needs of the business. Assume that the co-op will need sufficient cash to pay a competent and experienced manger to administer its day-to-day operations from the beginning. Using this assumption and typical industry parameters, a co-op steering committee and/or its business consultant can arrive at financial projections for business start-up. Based on these estimates, co-op organizers can explore what combination of debt and equity meet projected start-up capital requirements. The box to the right contains some questions for a new board to consider in setting up the equity structure of a co-op.

Some questions to ponder in setting up a cooperative financing structure:

- Is the business large or small?
- What are the desires/prospects for profitability and growth?
- Is the business labor or capital intensive?
- How much working capital is needed for inventory/seasonal needs?
- What level of profits from operations can be expected to be reinvested in the business?
- Is the membership base expected to grow or remain stable?
- How does expected member growth compare with expected business growth?
- Will the capital needs of the co-op grow or shrink as the business matures?
- What is an acceptable time horizon for start-up and reinvested equity to be returned to your members? Do they need or expect a financial return annually? Would they wait 5 – 7 years? Until retirement? Later?
- What would members expect to happen to the cooperatives assets in the event of dissolution?

A side note is that co-ops that attempt to capture or capitalize the value of initial member's volunteer labor may find themselves with an unexpected tax bill based upon that

value. In this, as in many other cases, consultation with an account familiar with cooperative law and practice is essential.

A related question to the one of how much member equity a co-op will need is the question of how member equity will be rotated out and repaid to members, a question that will be considered in more detail in the next section. The answer to both of these questions together will yield the equity structure of the co-op**.**

It is also worth keeping in mind that a co-op's capital needs do not necessarily remain static. If a business grows more quickly than its membership, for example, over time members may need to put in more equity; if the opposite is the case, members equity requirements may be relaxed. What works for a co-op and its members today may or may not be what works for the same enterprise a few years down the road. The point is not to be immobilized by the future unknowns, but rather to be thoughtful and plan the financial flexibility to meet the needs of past, present and future members. *Good capital planning is good strategic planning*, and it is important to consider all areas of capital need and not just the need for equity redemption.

The percentage of equity required to start a co-op varies a great deal from industry to industry and project to project, but it is not unusual for 40% or more of start-up funds to come from members themselves. Conversations with local and/or specialized cooperative lenders will yield a likely percentage of debt relative to equity based upon the loan to value ratio the lender utilizes in its collateral assessment. The difference must be made up either of member equity or subordinate debt.

Once a member equity figure has been established, a new co-op must also decide how that member equity requirement is to be divided among potential members. As a democratically run enterprise, membership is established through member stock or member share requirements that gives everyone the same voting privileges. Beyond the established minimum voting member share or membership fee required to become a co-op member, however, the co-op must also decide if certain classes of members or

frequent users of co-op services might be required to invest more in the business. Or will everyone pay the same amount? If not, what is an acceptable level of difference? As with many things, there is really no single correct answer to this question, but *it is good cooperative practice for the member equity requirement to be proportional to the expected member benefit*.

Cooperatives can provide benefits to members in a wide variety of ways, both economic and noneconomic. These are discussed in more detail in Section 5. An initial way to explore the issue of differential capital contributions might be to consider the marginal cost of providing benefits to members. For some co-ops, such as consumer co-ops where all members are free to use the cooperative as much or as little as they please at a minimal additional marginal expense, it might make sense for all members to pay a similar amount to finance the existence of the co-op store. For an agricultural marketing cooperative, however, where there is additional cost to the co-op for every transaction, it might make more sense to set member equity requirements based on use. Agricultural cooperatives sometimes use what is called a "base capital plan", which combines a target end member equity level for the entire business with a system of contributions by individual members that is proportional to use. (See sidebar.)

Base Capital Plans

Many agricultural marketing or service cooperatives like CROPP cooperative described on page 12 use a base capital plan for setting their member equity requirement. For many co-ops the primary source of new member equity is retained patronage refunds.

But this method, based on profitability, does not necessarily bear any relationship to the business's capital needs. In a base capital plan, the co-op board determines the total equity capital needed for a successful enterprise up front, and then sets target proportions for each member based upon relative use.

In the CROPP example on page 12, the requirement of each member is equal to 5.5% of a member's estimated annual gross income from products marketed with the co-op.

The US Department of Agriculture has several very useful publications on this topic.
http://www.rurdev.usda.gov/BCP_Coop_LibraryOfPubs-Subjects.htm

Many worker co-ops allow members to purchase their equity shares over time, with a set amount of pay taken out for member equity every paycheck until the full share is paid. If a co-op uses this system, it must also decide at what point the member be allowed to exercise his or her voting rights: whether this happens right away, only when the share is fully paid up, or at some point in between.

Every system will have its advantages and disadvantages. The important thing is to set up a member equity system that will provide a realistic share of the co-op's financing needs in the form of flexible and patient member equity capital.

Founding board members set an important tone with the way they structure member buy-in. An equity requirement that is set too low may result in members who are not committed to the co-op, and a seriously undercapitalized business. An equity payment requirement that is too high may place membership out of reach for many potentially highly contributing members. Whatever the system, it is imperative that the cooperative keep accurate record of members' equity accounts as well as their current address and contact information.

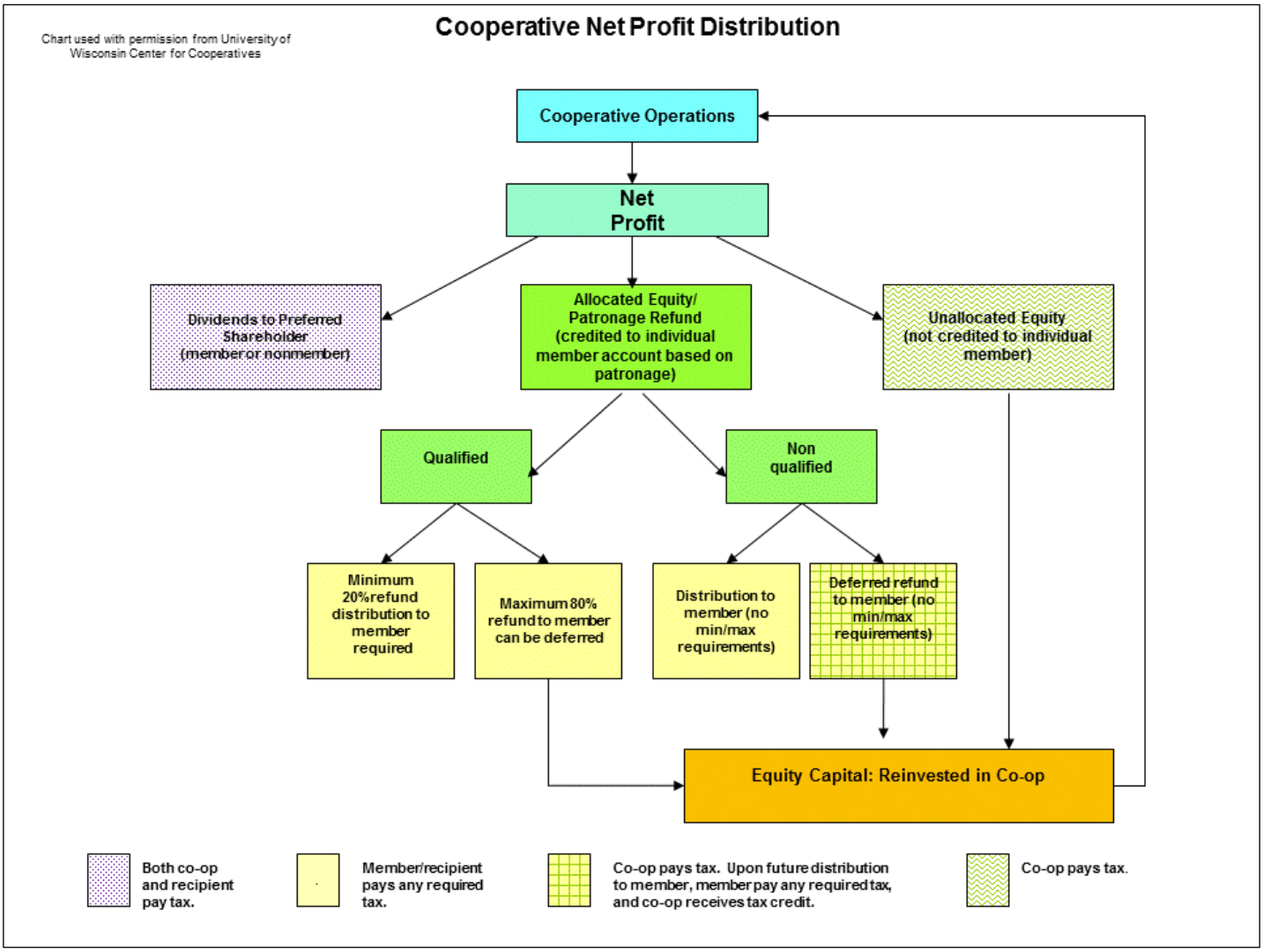
4. ONGOING CO-OP CAPITALIZATION

Businesses need capital not only for start-up but also to finance any ongoing needs to purchase, replace, or upgrade buildings and equipment or expand operations. In addition to "paid in" or contributed capital, the major source of equity for any privately-held business is the reinvestment of net profit after distributions to owners, if any, are made. Cooperatives are no different. However, the cooperative treatment of retained earnings and profit distributions has several unique characteristics.

When the cooperative business shows a net profit at the end of its fiscal year, the board decides what portion of the net profit is to be allocated and distributed to each member patron, and what portion remains the property of the cooperative as a whole. The portion of the overall net profit that is allocated to member patrons is apportioned to each member's account based upon the member's transactions with the cooperative, or patronage. Using patronage or use of the co-op (rather than capital invested or shares held) as the mechanism for the distribution of financial return is a defining characteristic of the cooperative model. For example, if a patron member's annual purchases from his or her grocery co-op totaled 1% of the co-op's annual sales, then that member would receive 1% of the annual profit allocated to member accounts. The board also decides what portion each member's annual allocated earnings will be retained by the co-op for a period of time as a source of owner equity to finance ongoing cooperative operations. Retained allocated equity allows member -owners to finance their cooperative in proportion to their use of the cooperative.

The unallocated portion of net earnings becomes equity that is "owned" by the cooperative entity as a whole. The value of this equity would typically only be divided among individual members in the case of sale or dissolution and according to the bylaws of the cooperative. These unallocated profits are another source of retained earnings for

the co-op, are reinvested in operations, and can absorb any losses that the cooperative business might incur from time to time.



Tax considerations also influence a board's decisions about allocated and unallocated equity. While the cooperative's retained earnings that are unallocated are taxed at the corporate rate, the taxation of cooperative net profits that are allocated to patrons may be handled in several different ways, but are subject to only single taxation. Application of the single tax principle to patronage allocations recognizes the distinctive relationship between members and their cooperatives, and allows the members to provide needed equity on an ongoing basis[2].

[2] United States Department of Agriculture, *Income Tax Treatment of Cooperatives: Patronage*

If the allocations of net earnings are designated by the cooperative as "qualified", then it is the cooperative members, and not the cooperative itself, that assume the tax liability and pay taxes at the individual rate. Federal tax law requires that at least 20% of qualified allocations be distributed to members in cash, primarily so that members can pay the tax obligation on both the distributed and the retained portion of allocated earnings. Because members have paid income tax on their allocated patronage that is retained by the cooperative, it is reasonable that they would expect that this equity would be returned to them at some point according to whatever equity redemption plan has been developed by the cooperative. The Premier cooperative case study on page 34 illustrates how one cooperative dealt with the issue of planning for equity redemption.

One exception to the above is if a cooperative's goods or services are sold at retail to their members for "personal, living or family use" and are not deducted by those members as a business expense, then profits that are allocated or distributed to members based upon those purchases are not subject to income tax, since the profits can be considered a type of refund. This is the case with most consumer cooperatives.

Allocated net earnings may also be designated as "nonqualified". In this case, the patron member only pays tax on the portion that is distributed in cash. The cooperative assumes the tax liability and pays taxes at the corporate level on the portion of allocated equity that is retained. There are no minimum or maximum requirements for the distribution of nonqualified allocated equity to members. At the time that the cooperative distributes the retained portion of the nonqualified allocated equity to each member, the cooperative claims a tax credit, and the member pays tax on the distribution, if applicable.

Many cooperatives also conduct some portion of their business with non-members. The portion of profit attributed to these transactions can be another source of retained earnings for the cooperative.

Refunds and Other Income Issues, Cooperative Information Report 44, Part 2, Donald A. Frederick, 2005. page 3.

Allocation considerations

Decisions about allocated and unallocated equity, qualified and nonqualified allocations, and between cash and non-cash distributions may vary quite dramatically between cooperatives operating in different industries. Even the same co-op may decide to allocate funds quite differently year to year depending upon tax considerations and long and short term capital needs. The example of Equal Exchange illustrates an interesting example of a social purpose co-op whose members have decided to donate any shared equity to charity if the co-op were ever dissolved.

It is worth noting again here that financial returns to co-op members in the form of patronage dividends is but one of the ways that cooperatives provide benefits to their members. Cooperatives deliver many and varied benefits to members in addition to passing along a portion of profits. Yet the method the co-op uses to allocate and distribute whatever profits occur says much to the member about the fundamental values of the cooperative. The decisions are an important statement of priorities, and an annual opportunity to share those values and priorities with members.

Paying It Forward

Equal Exchange is a worker-owned cooperative coffee company started with the audacious idea of paying coffee farmers in developing nations a stable and fair return for their wares, no matter what the international commodity market said the price should be.

For over 25 years, Equal Exchange has been a leader in the fair trade movement, linking U.S. consumers to farm families across the world, building a profitable company and posting annual sales in excess of $40 million. In addition to being a pioneer in fair trade, Equal Exchange has also been an innovator in socially responsible finance.

Countering the trend among even socially-motivated businesses to finance growth through investor-motivated capital and corporate partnerships, Equal Exchange has instead offered coffee drinkers the opportunity to purchase preferred shares with no voting rights and only a modest rate of financial return. Consumers responded with millions in investment.

While worker-owners at Equal Exchange earn a nice share of profits each year, they also understand that maximizing personal financial gain will never be the driving objective of their co-op; corporate bylaws dictate that in the event of dissolution or sale of the company, after settling all obligations any funds remaining in collective reserves or residual value would be distributed to another fair trade organization.

Worker Cooperatives and Internal Capital Accounts

Worker cooperatives are another cooperative sector in the U.S. that often operate with a system of "internal capital accounts" or member capital accounts which enable them to track the contributions and equity holdings of individual worker members over time.

Typically the internal capital account will have two parts: the initial equity contribution and the allocated retained patronage. Similar to other types of co-ops, the initial member equity contribution is a set amount determined by each co-op that every member must make in order to qualify as a member. Once paid, this amount does not change over time, and is typically paid back immediately upon departure. Some co-ops set the initial membership amount at as little as $25 or as high as $10,000 or more. If substantial, the co-op will normally make arrangements to help the co-op member to pay at least a portion of the membership fee over time through payroll deduction or some similar plan.

The retained patronage portion of the member's account is made up of their allocated share of annual profits that are paid in the form of member equity rather than cash. Each year, a portion of annual surplus is allocated to members based upon their use or "patronage" of the cooperative. In worker co-ops, a member's "patronage" is typically determined by hours worked, but also sometimes by relative pay, seniority, or a combination of all three factors. As with other co-ops, at least 20% of annual patronage allocations that are "qualified, must be paid in cash. The rest can be paid in equity or shares, which in a worker co-op are held in the member's internal capital account as retained patronage.

In some worker co-ops, the retained patronage portion of an individual capital account will earn a small declared dividend per year. Other co-ops consider the entire annual patronage payment to be in essence a dividend on the members' initial equity contribution in the co-op and therefore do not pay an additional amount.

The sum of each member's initial equity and retained patronage put together will represent the portion of the net book value of the corporation attributable to that member.

As with other co-ops, the schedule for equity payout or redemption of a member's internal capital account will vary. While membership equity contributions are always kept by the co-op for as long as a person is a working co-op member, most worker co-ops make an attempt to redeem or pay out the retained patronage portion on some sort of schedule. This schedule may range from 3 – 5 years after it has been earned (that is, patronage earned in 2012 and retained might be paid in cash in 2015), to in some cases more than 10 years. A few worker cooperatives do not pay out any retained patronage until a member retires or otherwise leaves the co-op.
As in all co-ops, financial practices require a balancing of interests between the members' individual interests and the financial needs or objectives of the cooperative as a whole.

A co-op is a better co-op when it effectively meets the needs of its members. Cooperatives are good at delivering benefit to members in part because they are so flexible. A co-op does not have to have a complicated system of equity allocation and distribution to meet the needs of its membership, but the ability to tailor important elements of the ownership structure for the good of the membership is one of the things that helps co-ops to serve their members well.

Equity Redemption Plans

Co-op members provide the crucial flexible and patient equity capital to launch a new cooperative, and to help an existing one achieve financial stability. Equity shares represent ownership of an enterprise, and ownership by an active and committed group of members strengthens a cooperative in many ways. But what happens when a member leaves a co-op? When they retire or leave their job at a worker co-op, move out of the area served by their consumer co-op, stop farming and marketing product through their producer co-op or otherwise cease to use the core functions of a co-op they have been an active member of? Should they still be owners of the business?

Since the cooperative is organized and operated to benefit its patron members, most co-ops prefer that only active members be involved as owners -- and therefore decision-makers -- of the business. Thus every cooperative must articulate a system not only for raising money from new members, but also for redeeming or returning equity to departing members. All decisions about capital redemption involve achieving an optimal balance between the solvency needs of the cooperative and the personal interests or desires of members.

Cooperative practices for the return or redemption of member equity vary dramatically, from immediate redemption upon departure to redemption only after the death of a member. Some of the differences are attributable to tradition or common practice within different cooperative sectors, while other variations have more to do with member expectations and the different fundamental benefits that the co-op is delivering to its members.

Consumer cooperatives, for example, might pay patronage refunds from time to time in cash but rarely return allocated equity to members. This is likely due to a combination of factors including the fact that with sometimes thousands of members, individual equity account balances are generally not large. Unlike other sectors, consumer co-op members do not pay personal tax on the patronage that is retained, and consumer co-op members generally consider the ongoing existence and improvement of the cooperative to be their prime benefit, along with occasional discounts, members' specials and some cash patronage refunds. Most consumer cooperatives only redeem retained member equity upon dissolution of the co-op, and members typically expect only their voting shares to be returned to them as long as the co-op is still in existence.

The case is often different for worker cooperatives, where the number of members is much smaller, internal equity account balances can be quite substantial, and one of the key benefits for members *is* remuneration or return based upon participation (in this case, work) in the cooperative. While practice varies widely, most U.S. worker co-ops combine an annual payout of profits in cash with delayed payout of other qualified equity over a multi-year schedule, typically three to seven years. Some treat allocated member equity as a retirement vehicle and pay funds out only upon departure or retirement.

Producer cooperatives in the U.S. have often depended heavily on retained allocated equity for their financing needs and have historically held onto retained allocated member equity for many years -- 18 years on average according to a study by USDA[3] -- and sometimes only returning member equity to the estate of a member after death. For some members this may be no hardship, as they have received numerous other benefits from the cooperative in the intervening years, including lower prices for inputs or better markets for their primary farm business. For other members, however, the situation may be less than optimal particularly considering that, unlike consumer cooperatives, the individual co-op member has had to cover any tax liability not met by annual minimum cash distributions. Recently, some farmer co-ops have modified their equity

[3] United States Department of Agriculture. "Cooperative Equity Redemption", Rural Business-Cooperative Programs Research Report 220, June 2010.

redemption practices, paying more to members on a cash basis, and reducing member tax liability by placing more funds in unallocated or unqualified accounts. The case of Premier Cooperative on the following pages demonstrates how one co-op dealt with these issues in a very effective way.

Premier Co-op: Adapting Member Equity Policy to a Changing World

A lot has changed in Mt. Horeb, Wisconsin since 1893 when Premier Cooperative was first started. Back in those days, Grover Cleveland was President and Premier was known by its former name, Patrons' Mercantile Cooperative. Patrons' was started in the neighboring town of Black Earth to give local farmers an affordable means to source a variety of supplies, while receiving a fair price for the goods they produced. Today Premier has facilities in 15 communities and operates a diverse array of agronomy, conventional and organic feed, supply, and grain marketing divisions in addition to four convenience stores, propane and bulk petroleum supply, two hardware stores, HVAC, lumber yard and three auto/truck and tire repair centers. Yet even as the world has changed, some things seem never to. One of those things is cooperative equity management programs, and Premier's was one of them.

When General Manger Andy Fiene first arrived at Premier 26 years ago, the Co-op's member equity redemption policy was much like those of any of its neighboring farmer cooperatives: Members shared in the profits of the co-op each year through their patronage dividends. Yet most of the funds (a maximum of 80% per year) were paid to them in the form of stock rather than cash. The stock would then be retained by the Co-op for an indefinite period of time. Since the whole patronage allocation, whether in stock or in cash, was taxable to the farmer members in the year it was declared, in many cases members ended up paying out more in taxes every year than they received in cash from their patronage allocation. To make matters worse, the Co-op held on to the stock portion of patronage for decades. At the time Fiene started as general manager in 1992, the average age at which a member of Premier might expect to get even a portion of that retained stock redeemed to them in cash was 78. This might well be 40 years after the earliest of this equity was "earned" by the member. In many cases, the funds had to be paid to an estate because the member had died still waiting for his share of co-op profits to be returned to him in cash. Due to four straight years of losses prior to Fiene starting as general manager, the cooperative had ceased age retirements and fallen behind on estate redemptions, making matters even worse.

Understandably, members did not like this system too well, although it was very common among farmer co-ops at the time, and still is today. Fiene didn't really like it either, but for different reasons. When he started projecting out what would need to happen to enable the co-op to shorten this timeline and redeem member stock on a shorter, more meaningful timeline, he and his board members were surprised at what he found -- given reasonable financial assumptions for their business and its growth, not only would Premier be unable to
projecting out what would need to happen to enable the co-op to shorten this timeline and redeem member stock on a shorter, more meaningful timeline, he and his board members were surprised at what he found -- given reasonable financial assumptions for their business and its growth, not only would Premier be unable to shorten the payment period for members, in fact the timeline was likely to just continue to get longer. There was no way that Premier could "grow its way" out of the situation without sacrificing future investment in vital business functions. On paper, the system was simply not sustainable.

Instead, the co-op took a good look at its evolving business interests and changing membership and crafted a new member equity system that works better for all parties, one that retired the member equity that the co-op was already

(Continued next page)

(Continued from previous page)

obligated to while limiting future liability. First, recognizing that many of the purchases at the co-op's retail convenience, hardware store and lumber yard were quite small, the co-op limited patronage payments to members making a minimum of $1,500 per year in purchases. This cut down on paperwork and recordkeeping while ensuring that patronage payments were only going to those members who did a substantive amount of business with the co-op. Second, instead of declaring the majority of member patronage payments to be "qualified" allocations and therefore the tax responsibility of the individual members, the co-op still kept track of individual members' portions but declared the allocations "nonqualified," meaning the cooperative pays the tax on the equity portion allocated.

By removing the tax burden from the members, the cooperative feels less obligated to retire the "nonqualified" equity than it does the "qualified" equity its members previously were issued and paid tax on. If the cooperative does decide to retire any amount of the "nonqualified" equity in the future, the farmer members will only have to pay tax (and the co-op will get a refund of the tax previously paid) at the time the member actually receives the cash. Third, the Co-op studiously tracked down which member transactions were attributable to consumer members (and therefore not taxable as patronage since consumer members do not report their purchases as business expense deductions on their taxes) and allocated those members "qualified" equity rather than "nonqualified". This saved the co-op money, but did not pass a commensurate burden onto the member.

The net result is that the cash portion of the annual patronage allocation has increased from 20% to what has ranged from 30% to 57% since its inception, while personal tax liability of co-op members has decreased appreciably, making the cash portion of their annual payment more meaningful. At the same time, the timeline for redeeming the stock previously allocated to members under the old plan has decreased appreciably. In 2013, Premier members age 65 and older received their eligible retirement equity, instead of 78 (the average age when the new program started), and the expectation is that the age will continue to decrease until all of the old qualified patronage has been returned to members. At that time, the Co-op will evaluate annually how to treat the "new" equity.

The new system "requires a lot hard work" in the form of record-keeping "if you want to do it the right way" , but has also pushed the co-op to operate in a much more business-like manner in terms of their cash planning. The co-op retains a great deal of flexibility in whether or not to revolve the nonqualified equity down the line, and since members have not been required to pay tax on it, they are more willing to accept their allocated equity as an investment in the future services of their cooperative. While some cooperatives might take the easier route and just seek to delay any redemption to members indefinitely, Premier's board and management understand that the value of the co-op was built upon business with members and there is a balance that must be struck between the interests of the co-op and its members. Fiene states that "while this type of program may not fit other cooperatives, for our cooperative it was an important change that has helped us grow our value to our members."

"Most (co-ops) are afraid to rock the boat and talk to their members about the problems the old system creates. People inherently fear change," says Fiene. But as he has shown, a willingness to confront such a problem with creativity and insight could mean a better solution for both the co-op and its members.

One approach that has been used by some cooperatives which have sizable internal member equity accounts that the cooperative intends maintain for some number of years, possibly past the time when the member is no longer active with the co-op, is to convert the retained qualified member equity of retiring or departing members into preferred shares. That way the funds remain as equity on the co-op's balance sheet which helps the cooperative financially, but they do not confer voting rights to members who are no longer active within the co-op. For the retiring member, the advantage of this arrangement is that he or she begins to receive a stream of cash dividends on retained equity accounts as well as preferential repayment over active members in the event of dissolution of the co-op.

Developing an equity redemption plan can help ensure that current active members are proportionately financing their cooperative, and all members are being treated equitably in terms of equity redemption. The two most common types of plans include the revolving fund plan, and the base capital plan. A revolving fund plan pays out the oldest retained equity and replacing it with newer retained equity from current member activity on an annual basis. While the simplest to implement, fluctuating or declining business profitability can pose challenges to this approach. A second method is the base capital plan described on page 24. With a base capital plan, the board of the co-op periodically establishes a targeted amount of equity that the co-op needs to fund its ongoing operations. Member equity requirements are set based upon that calculation. Members can fulfill these financial obligations through a variety of means, including allocated equity or per-unit capital retains. And as with any equity redemption decisions, it is good practice to seek the advice of an accountant with expertise in cooperative finance matters.

Thinking about Equity

Cooperative boards need to be mindful about balancing the interests of different members in decision-making about allocation of net profits. Stretching out equity redemption may be good for the balance sheet of the co-op and an efficient way to fund growth, but may be unfair to members close to retirement who won't benefit from the

growth they are disproportionately funding. In contrast, adopting a member equity redemption plan that is too aggressive can strain the co-op financially and even threaten its existence. In co-ops with a long history of profitability, newer members reap the benefits of substantial previous equity accumulation while having contributed relatively little themselves, a situation some view as unfair. On the other hand, there have been cases where a large block of retirement age members have voted to dissolve a co-op that they no longer need in order to monetize their equity investment quickly, leaving younger members without jobs or access to the co-op's ongoing services.

There are no perfect answers to equity allocation and redemption questions, as each situation is different. The important thing for a co-op's board and management to keep in mind is to *manage member expectations and be clear and consistent about communicating the broad range of benefits of cooperative membership*. The conversation should not focus solely on profitability and equity redemption to the exclusion of other important ways in which the co-op benefits its members and community. Co-op leaders must also be mindful at all times of balancing the interests of current, past and future members and the sometimes competing needs of co-op solvency and maximum member benefit. They also must be aware of the implications of different equity redemption plan options, making sure that the decisions they make are right for members in the long term as well as the short.

While the range of available choices may seem confusing, it also means that cooperatives have flexibility to come up with creative and balanced ways to satisfy the needs and desires of their own particular constituencies. Cooperatives have a range of tools available to create a thoughtful and balanced allocation of benefit among members.

Many experts encourage every co-op board to create a specific capital plan that matches the projected capital needs of the business with the likely growth in members, expected new equity contributions and desires of members for equity redemption. Such a tool can help a co-op board allocate funds strategically to protect the co-op's liquidity and long-term solvency, while delivering the highest level of financial benefit to

members. Some large co-ops like CoBank actually publish their annual capital plan to provide an easy means to discuss these important matters with members. It is also an opportunity to remind members that without the co-op, there might be no benefit to allocate.

5. BENEFITS OF COOPERATIVE MEMBERSHIP

As is clear from the preceding discussion, with their limited return invested capital and often leisurely equity redemption schedules, cooperatives are not very effective as a get-rich-quick scheme. So why would a rational person chose to invest funds in such an enterprise?

Cooperatives are economic enterprises, but they are not driven by investment return. They are designed to provide member benefit, but that benefit may be defined and derived in a myriad of ways, social and cultural as well as economic. And even within the economic sphere, cooperatives typically also offer their members a wide variety of benefits in place of or in addition to, the financial returns they receive based upon their patronage.

*Focusing too much on the limited capital returns of equity invested in cooperatives profoundly under-estimates the potential benefits of cooperative enterprise***.** The indirect economic returns or "use value" of cooperative membership to farmers or small business owners in making their own enterprises more efficient and profitable are generally far more significant, for example, than the limited return they might receive on their co-op shares. For individual consumers as well, the indirect economic benefits of better product pricing, access, and information are typically of much more value than their return on co-op stock. The ability to treat business profitability as "the rules of the game rather than the objective" also frees cooperatives to invest in and engage in a range of pursuits to benefit their members and their community over a longer period of time without having to worry about earning immediate returns for investors.

There are many ways that co-ops economically benefit their members in additional to investment or patronage returns.

Group purchasing discounts

Many co-ops are organized for the primary purpose of accessing the economies of scale and group purchasing discounts that larger competitors enjoy. Consumer cooperatives are a prime example of this kind of cooperative, as are farm supply co-ops. Purchasing cooperatives made up of independent small business owners or franchisees are one of the fastest growing kinds of cooperative in the U.S. today. Such purchasing and shared service cooperatives like ACE Hardware enable independently-owned stores to access the superior pricing and advertising buys of a corporate chain. Best Western is the world's largest hotel chain providing a sophisticated international reservation network for the independent operators of its 4,000 hotels.

Group purchasing is not limited to privately-held businesses – the Western Area City County Cooperative (WACCO) in Northwestern Minnesota pools the buying power of almost three dozen municipalities to save money on everything from road salt to staff trainings.

Secondary or federated cooperatives (co-ops of co-ops) are also commonly formed for the purpose of joint purchasing and advertising. The formation of the National Cooperative Grocers Association (NCGA) allowed its 130+ independently-owned consumer food co-ops to pool their billion dollar buying power and negotiate significant discounts from common vendors, dramatically improving individual store profitability. While some savings are directly passed on to members, other funds are used to design and deliver training and other resources to further improve store efficiency and also to fund the development of new cooperative stores.

Access to markets and anti-monopoly force

When there is only a single purchaser of a product in a marketplace or when one player effectively controls transport, storage, certification or other vital functions, small players are bound to be the losers. Cooperatives can be formed to counter such monopoly market power and give small producers access to fair and reasonable pricing,

transport, and storage of goods. Many farm co-ops in the U.S. were started for this very reason, and cooperative creameries and grain silos were a common feature of the rural landscape a generation ago. Co-ops of coffee farmers in developing countries help ensure that quality grading of coffee beans is done in a fair and transparent fashion. There are also many examples where the very existence of a cooperative alternative significantly affects the actions of competitors, often yielding lower prices for all consumers, both co-op members and non-members alike.

Better information and technology

In the information age, co-ops can provide tremendous benefit to their members' farms or businesses by enabling them to access the kind of sophisticated market data or technology that only large corporations can usually afford. Farmer cooperatives, for example, offer agronomy and related services to assist their farmer members to run more efficient operations.

Shared risk

Mutual insurance companies are one of the oldest forms of cooperatives and are formed to help individuals or small businesses manage risk in an affordable and predictable way. Ben Franklin is said to be one of the founders of the oldest U.S. cooperative still in existence, the Philadelphia Contributionship for the Insuring of Houses from Loss by Fire, which was founded in 1752.

Innovation

Many co-ops members rely on the power of their combined purchasing dollars to access new or unusual products that may not be available in the conventional marketplace, or to create more availability where supplies of an established product are lacking. Natural foods cooperatives in the U.S. built their market on access to products that were simply unavailable at conventional grocery stores. Even today when many natural foods products can be easily found in traditional grocery stores, consumer food

co-ops typically carry a significantly higher number of unique products than do other food stores.

Access to goods and services

Rural electric cooperatives were formed in the 1930's in the U.S. to provide vital electric service to rural Americans,since rural markets were not sufficiently dense to attract investor-owned electric companies to serve them. And in 21st century Manhattan, concerned parents are increasingly taking matters into their own hand and forming their own pre-school cooperatives as the number of places available in any nursery school at all continues to lag behind the number of pre-school age children who need places.[4]

Better product information

Consumer co-op members around the world trust their co-op to act on their behalf and access and relay important information about food provenance and quality so consumers can make more informed purchasing decisions.

Joint services

Small businesses or franchise owners in a similar industry can join together to coordinate important backroom office functions, marketing and other useful and necessary functions, giving members greater access to a wider variety of professional services at a lower cost. For example, Thanexus is a cooperative of funeral home operators, providing members with shared human resource, communication, and financial services. Such joint services allow co-op members access to professional-level services while freeing up their own time to concentrate on activities that uniquely add value to their own businesses.

[4] Sangha, Soni. "The Pre-K Underground" *New York Times*, December 16, 2012.

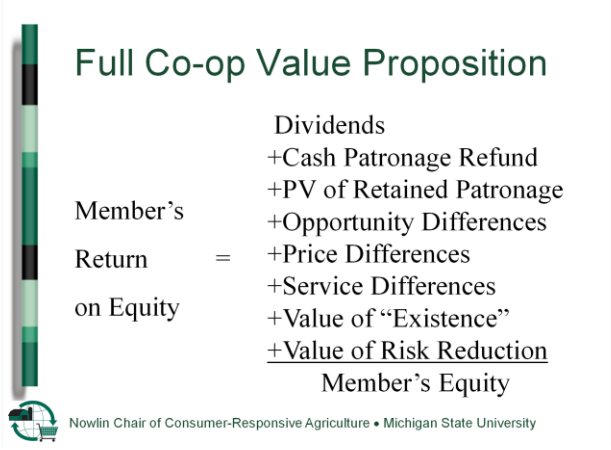
Common facilities

Housing cooperatives offer many low-income individuals access to home ownership opportunities that they would not be able to afford otherwise. Recreational properties such as camps and cabins can also be owned in common, making them more affordable and accessible. Mesaba Co-op Park in northern Minnesota is one of the oldest continuously operating co-ops of this type. It was founded in 1929 by Finnish immigrants for the purpose of providing "common festival and camping grounds." Some single family home owners also join together to invest in common areas for playgrounds and other recreational uses.

Though less common than residential cooperatives, small businesses can also own commercial property in common, sharing upkeep and enforcing quality standards. The Quartier Petit-Champlain in Quebec City, Quebec is an example of such a co-op. This group of historic shop buildings, which date back to the beginning of the 17th century, are cooperatively owned. Ownership of these important properties not only delivers to shop owners a guaranteed long-term lease, itself a significant economic benefit. It also allows members to exercise control over property use, keeping out chain stores and limiting leases to independently-owned enterprises that carry goods which reinforce the area's reputation for high quality unique products.

It is important to note that while all of these economic benefits are real, some are more easily quantifiable than others. It is the job of the coop's board and management not only to deliver competitive advantages to members on a regular and meaningful basis, but also to make sure that members understand and appreciate the value that the co-op brings. It is also the job of the board and management to make sure that cooperative benefits keep pace with current member needs, and that the cooperative continue to make the lives of its members better in ways that they can clearly see. A co-op that loses the ability to touch their members' lives in regular and meaningful ways is a cooperative that is vulnerable to replacement and extinction.

Using a standard "return-on-equity" model clearly cannot capture the many and varied potential economic benefits of cooperative enterprise. Understanding the true benefit of cooperative enterprise entails a combination of short- and long-term calculations, and an appreciation for a range of benefits from discounts and group purchasing power, to the benefit derived from inhabiting a world with more market choices, enhanced security for small economic players, greater transparency and a heightened sense of common purpose.



Dr. Chris Peterson, 2008 Farmer Cooperatives Conference
www.uwcc.wisc.edu/outreach/FCC/PastConferences/farmercoops08/program.html

6. CONSIDERATIONS AND CONSEQUENCES OF CAPITAL DECISIONS

Building your Co-op for the Long Haul

The link between capital structure, membership profile, risk appetite and benefit distribution is a complex one. The decisions that a board makes regarding the capital structure of a co-op have major implications for the health and longevity of the enterprise. The good news is that, as the Premier Farm Co-op case study on page 34 illustrates, it is possible to change a co-op's capital management program if it is not meeting the needs of the cooperative or the current members.

A key question is one of longevity, and the ability of the cooperative to expand or reinvent itself as the initial member needs are satisfied and market failures are corrected. A rural electric cooperative may also offer energy conservation programs to its customers, or access to internet or cable services. A natural food co-op may become the "go to" place for locally produced foods as well as organics, bulk foods and other specialty products. A producer marketing cooperative may expand the range of agricultural products and types of producers that it supports. If members are building their cooperatives for the long haul to not only serve current members but to help future members to solve the problems of their own generation, then they and their boards must mindfully build this objective into the capital formation and equity redemption structure of the cooperative. Failure to do so can lead the co-op to become irrelevant, devaluing the sacrifices of its founders and missing the opportunity to provide meaningful benefit for a new generation of members.

As memories of the original founding opportunity or grievance fade, however, and as services and territory expand, the cooperative's membership will likely grow

more heterogeneous, and may see less and less reason to support each other's objectives. In such cases, pressure has typically increased to make the co-op behave more and more as a conventional investor-driven corporation. To retain the founding common impetus of the cooperative and ensure it will survive and thrive over generations of members, it is imperative that a board make sure that that the "present value" of the cooperative as well as its future value is beyond question. Boards can work to:

- Ensure that the use value of the cooperative is broadly shared and understood (making sure its services remain timely, relevant and meaningful);

- Practice active balance sheet management, setting liquidity and solvency targets for the co-op enterprise as a whole and then matching these targets to a member equity redemption plan that encourages those who reap the most benefit from the co-op to also lead in capitalization. Consider setting up a base capital or similar program to make member capital contribution expectations more transparent to members and returning equity in the form that is most valued by members;

- Actively plan for the future of the enterprise, thinking about market opportunities that the cooperative might pursue and the kind and nature of capital that would be required to fund such expansion;

- Make deliberate use of the flexibility allowed to cooperatives to combine allocated and unallocated, qualified and nonqualified, cash and noncash returns to members to balance short and long term cash flow needs of the co-op with needs and desires of cooperative members;

- Creating incentives for board members, management and the membership to act in the long-term interest of the organization. Remove incentives that seem to pit one group of members against another, and instead seek solutions that

acknowledge the needs of all. Examine what behavior is rewarded in your cooperative's existing financing structure and align (or realign) rewards to encourage the behavior you seek;

- Ensure that any residual assets from the cooperative, if sold, would be distributed to the membership broadly and equitably and not unfairly benefit a small group of current members or managers at the expense of the whole. One first step might be to ban board members and management from benefiting personally from speculative gain in the sale of a cooperative to remove personal motivations from the equation;

- For co-ops with long-term social as well as economic objectives, consider following the lead of Equal Exchange and designate in the bylaws that unallocated equity go to a social or nonprofit purpose upon dissolution, instead of making these funds available for distribution to members. In this way the social objectives of the cooperatives would live on even after cooperative dissolution.

Center for Cooperatives
UNIVERSITY OF WISCONSIN–MADISON

427 Lorch Street

Madison, WI 53706

www.uwcc.wisc.edu